

Handwritten: "Hewlett" and "83" with initials.



North America Equity Research
26 March 2008



Fairpoint Communications

FRP Set to Close Deal; Buy on Weakness Following Distribution

Deal set to close; bond terms worse than expected; thesis still intact. After market close, FRP announced it priced \$551MM of bonds at 13.125%. This puts the Verizon Northeast transaction on track to close on Monday with the distribution after the close on Monday. We would use the technical pressure and liquidity from the distribution to build a position. (This report includes pro forma forecasts updated for bond deal).

Debt terms a little worse than expected. Coupon on bonds came in at 13.125% vs. prior est. of 9.5%. This reduces our FCF est. by \$20MM to \$183MM for 08. However, with an adjusted 08E FCF yield of 21% (fully taxed) compared to a group avg. of 12%, FRP remains the most attractively valued name in the group.

- **Delevering targets still achievable.** FRP has committed to reducing leverage to 3.6x by the end of 11. Based on our revised estimates, which are more conservative than mgmt guidance, we estimate leverage exiting 11 of 3.3x. EBITDA would have to miss our forecasts by 5% in each of the next four years for FRP to miss the leverage threshold.
- **Integration risk significant but manageable.** Integration challenges are considerable given acquired assets are 5x larger than legacy FRP; VZ likely underinvested; transition to new billing / back office systems required; cost reduction limited by conditions set by regulators/unions; and mgmt has previously struggled with simpler integrations. However, we have accounted for integration risk with EBITDA est. below guidance. EBITDA would have to miss our est. by 15% for FRP to be trading in line with peers on 08E FCF, which we think is unlikely.
- **See 35-40% Upside.** We base our \$15 Jan 09 PT on a 14.5% FCF yield applied to 08E FCF/share of \$2.08 (and adding PV of NOL of \$0.71). This assumes that FRP continues to trade at a 20% discount because of integration risk (peer multiple would imply price of \$18).

Fairpoint Communications (FRP;FRP US)

	2006A	2007E	2008E
EPS (\$)			
Q1 (Mar)	0.17	0.14A	
Q2 (Jun)	0.20	0.12A	
Q3 (Sep)	0.17	0.13A	
Q4 (Dec)	0.15	0.16	
FY	0.68	0.55	0.45

Source: Company data, Reuters, JPMorgan estimates.

Overweight

\$10.52

26 March 2008



Wireline Services/Incumbents

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Company Data

Price (\$)	10.52
Date Of Price	26 Mar 08
52-week Range (\$)	20.16 - 8.55
Mkt Cap (\$ mn)	365.04
Fiscal Year End	Dec
Shares O/S (mn)	35
Price Target (\$)	15.00
Price Target End Date	30 Jan 09

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See page 8 for analyst certification and important disclosures, including investment banking relationships.

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Summary Financials

In the tables below we show our updated forecasts for FRP pro-forma of the VZ Northeast acquisition. Please see our full report published on December 12, 2007, for further details.

Table 1: Financial Summary

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR (‘08E-12E)
Revenue	1,394.8	1,346.9	1,309.4	1,283.6	1,264.8	-2.4%
EBITDA	510.5	513.0	497.5	481.3	469.3	-2.1%
FCF	183.4	202.7	210.9	213.6	220.3	4.7%
FCF Yield	19.8%	21.9%	22.8%	23.1%	23.8%	NA
Dividend/share	\$1.03	\$1.03	\$1.03	\$1.03	\$1.03	0.0%
Net Debt/EBITDA	4.0x	3.8x	3.7x	3.6x	3.4x	NA
Adjusted Net Debt/EBITDA	3.8x	3.6x	3.5x	3.3x	3.2x	NA
memo: EBITDA margin	36.6%	38.1%	38.0%	37.5%	37.1%	
memo: Est. Dividend yield	9.8%	9.8%	9.8%	9.8%	9.8%	
memo: Est. Dividend payout	49.5%	44.8%	43.1%	42.5%	41.2%	

Source: JPMorgan estimates, FactSet, and Company data. Note: Adjusted leverage reflects \$30 million add back to EBITDA for pension and post retirement benefits (OPEB) accounting adjustments (cash paid is expected to be less than accounting expense).

Table 2: Revenue Estimates by Entity

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR (‘08E-12E)
Verizon Northeast Standalone						
Local voice	1,032.3	984.0	948.5	923.3	906.4	-3.2%
Long distance	88.1	89.1	89.0	88.5	86.6	-0.4%
Data/Internet	98.2	113.2	125.5	135.6	144.0	10.0%
Other	18.0	17.0	15.0	14.0	13.0	-7.8%
Eliminations	(118.4)	(128.8)	(137.5)	(142.8)	(146.6)	NA
Total revenue	1,118.2	1,074.5	1,040.5	1,018.5	1,003.5	-2.7%
memo: Growth Y/Y	NA	-3.9%	-3.2%	-2.1%	-1.5%	
Fairpoint Standalone						
Local voice	189.6	180.9	173.5	166.7	160.4	-4.1%
Long distance	31.5	32.3	32.9	33.2	33.5	1.5%
Data/Internet	36.9	40.4	43.2	45.5	47.3	6.4%
Other	18.5	18.9	19.3	19.7	20.1	2.0%
Eliminations	0.0	0.0	0.0	0.0	0.0	NA
Total revenue	276.6	272.5	268.8	265.1	261.3	-1.4%
memo: Growth Y/Y	NA	-1.5%	-1.3%	-1.4%	-1.4%	
Consolidated						
Local voice	1,221.9	1,164.8	1,122.0	1,090.0	1,066.8	-3.3%
Long distance	119.6	121.5	121.9	121.7	120.1	0.1%
Data/Internet	135.2	153.5	168.6	181.1	191.3	9.1%
Other	36.5	35.9	34.3	33.7	33.1	-2.5%
Eliminations	(118.4)	(128.8)	(137.5)	(142.8)	(146.6)	NA
Total revenue	1,394.8	1,346.9	1,309.4	1,283.6	1,264.8	-2.4%
memo: Growth Y/Y	NA	-3.4%	-2.8%	-2.0%	-1.5%	

Source: JPMorgan estimates, company data.

Table 3: Verizon Northeast Access Line Trends

in thousands

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
Consumer primary	750.0	691.1	643.7	605.2	573.8	-6%
+ Consumer secondary	65.2	56.0	48.4	42.1	36.6	-13%
= Total consumer	815.2	747.1	692.1	647.3	610.4	-7%
+ Business	316.1	301.9	289.7	279.1	270.0	-4%
= Total retail	1,131.4	1,049.0	981.8	926.4	880.4	-6%
+ Wholesale	104.6	96.6	90.3	85.3	81.3	-6%
+ Other	35.0	33.8	32.7	31.7	30.9	-3%
= Total access lines	1,271.0	1,179.3	1,104.8	1,043.5	992.6	-6%
memo: Net adds	(114.0)	(91.6)	(74.6)	(61.3)	(50.9)	
memo: Access line growth Y/Y	-8.2%	-7.2%	-6.3%	-5.5%	-4.9%	

Source: JPMorgan estimates, company data.

Table 4: Verizon Northeast Voice Revenue Drilldown

Access lines in thousands; revenue in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
Average access lines	1,328.0	1,225.2	1,142.1	1,074.1	1,018.0	-6%
Service ARPU	\$37.46	\$37.78	\$38.10	\$38.43	\$38.76	1%
+ Subsidy ARPU	\$1.36	\$1.38	\$1.39	\$1.40	\$1.42	1%
+ Access ARPU	\$25.96	\$27.77	\$29.72	\$31.80	\$34.02	7%
= Total local voice ARPU	\$64.78	\$66.93	\$69.21	\$71.63	\$74.20	3%
memo: Growth y/y		3.3%	3.4%	3.5%	3.6%	
Service revenue	597.0	555.4	522.2	495.3	473.5	-6%
+ Subsidy revenue	21.7	20.2	19.0	18.1	17.3	-5%
+ Access revenue	413.6	408.3	407.2	409.8	415.6	0%
= Total revenue	1,032.3	984.0	948.5	923.3	906.4	-3%
memo: Growth y/y	NA	-4.7%	-3.6%	-2.7%	-1.8%	

Source: JPMorgan estimates, company data.

Table 5: Verizon Northeast DSL Drilldown

Subscribers in thousands; revenue in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
Subscribers						
Residential DSL subs	199.7	219.6	234.1	244.2	250.8	6%
+ Business DSL subs	56.3	69.2	81.6	93.6	105.0	17%
= Total DSL subs	256.0	288.8	315.7	337.8	355.8	9%
memo: Net adds	40.0	32.8	26.9	22.1	18.1	-18%
memo: Growth y/y	18.5%	12.8%	9.3%	7.0%	5.4%	
Penetration of Access lines						
Residential	24%	29%	34%	38%	41%	
Business	18%	23%	28%	34%	39%	
Total retail	23%	28%	32%	36%	40%	
Total retail and wholesale	20%	24%	29%	32%	36%	
Revenue by Segment						
Avg Residential DSL subs	186.2	209.7	226.9	239.1	247.5	7%
x ARPU	\$29.25	\$28.52	\$27.81	\$27.11	\$26.43	-3%
= Residential revenue	65.4	71.7	75.7	77.8	78.5	5%
memo: ARPU growth y/y	-2.5%	-2.5%	-2.5%	-2.5%	-2.5%	
memo: Revenue growth y/y	12.4%	9.8%	5.5%	2.8%	0.9%	
Avg Business DSL subs	49.8	62.7	75.4	87.6	99.3	19%
x ARPU	\$55.00	\$55.00	\$55.00	\$55.00	\$55.00	0%
= Business revenue	32.8	41.4	49.8	57.8	65.5	19%
memo: ARPU growth y/y	0.0%	0.0%	0.0%	0.0%	0.0%	
memo: Revenue growth y/y	23.2%	26.1%	20.2%	16.2%	13.4%	
Avg Total DSL subs	236.0	272.4	302.2	326.7	346.8	10%
x ARPU	\$34.68	\$34.62	\$34.59	\$34.59	\$34.61	0%
= Total revenue	98.2	113.2	125.5	135.6	144.0	10%
memo: ARPU growth y/y	-0.9%	-0.2%	-0.1%	0.0%	0.1%	
memo: Revenue growth y/y	15.7%	15.2%	10.9%	8.1%	6.2%	

Source: JPMorgan estimates, company data.

Table 6: Verizon Northeast Long Distance Drilldown

Subscribers in thousands; revenue in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
LD subs	626.0	635.9	629.5	623.2	617.0	-0.4%
memo: Growth y/y	0.2%	1.6%	-1.0%	-1.0%	-1.0%	
memo: Penetration	55.3%	60.6%	64.1%	67.3%	70.1%	
Avg LD subs	625.4	630.9	632.7	626.4	620.1	-0.2%
x ARPU	\$11.75	\$11.77	\$11.73	\$11.77	\$11.64	-0.2%
= LD revs	88.1	89.1	89.0	88.5	86.6	-0.4%
memo: ARPU growth y/y	0.0%	0.2%	-0.4%	0.4%	-1.1%	
memo: Revenue growth y/y	0.5%	1.1%	-0.1%	-0.6%	-2.1%	

Source: JPMorgan estimates, Company data.

Table 7: Consolidated Subscriber Trends

in thousands

	2008E	2009E	2010E	2011E	2012E	CAGR (‘08E-12E)
Access Lines						
FRP standalone	224.6	212.5	201.5	191.7	182.9	-5%
VZ Northeast standalone	1,271.0	1,179.3	1,104.8	1,043.5	992.6	-6%
Consolidated	1,495.6	1,391.8	1,306.3	1,235.2	1,175.5	-6%
Access Line Growth Y/Y						
FRP standalone	-5.7%	-5.4%	-5.1%	-4.9%	-4.6%	
VZ Northeast standalone	-8.2%	-7.2%	-6.3%	-5.5%	-4.9%	
Consolidated	-7.9%	-6.9%	-6.1%	-5.4%	-4.8%	
DSL Subscribers						
FRP standalone	76.4	83.8	90.1	95.5	100.0	7%
VZ Northeast standalone	256.0	288.8	315.7	337.8	355.8	9%
Consolidated	332.4	372.6	405.8	433.2	455.8	8%
DSL Subs Growth Y/Y						
FRP standalone	12.9%	9.7%	7.5%	5.9%	4.8%	
VZ Northeast standalone	18.5%	12.8%	9.3%	7.0%	5.4%	
Consolidated	17.2%	12.1%	8.9%	6.8%	5.2%	
DSL Penetration						
FRP standalone	34.0%	39.4%	44.7%	49.8%	54.7%	
VZ Northeast standalone	20.1%	24.5%	28.6%	32.4%	35.8%	
Consolidated	22.2%	26.8%	31.1%	35.1%	38.8%	

Source: JPMorgan estimates, Company data.

Table 8: Verizon Northeast Standalone Margin Evolution

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR (‘08E-12E)
Revenue	1,118.2	1,074.5	1,040.5	1,018.5	1,003.5	-3%
- Expenses	754.8	737.3	723.7	714.9	708.9	-2%
= EBITDA	363.5	337.2	316.8	303.6	294.6	-5%
memo: Margin	32.5%	31.4%	30.4%	29.8%	29.4%	

Source: JPMorgan estimates, Company data.

Table 9: Revenue and EBITDA Estimates by Entity

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR (‘08E-12E)
Revenue						
FRP standalone	276.6	272.5	268.8	265.1	261.3	-1%
VZ Northeast standalone	1,118.2	1,074.5	1,040.5	1,018.5	1,003.5	-3%
Consolidated	1,394.8	1,346.9	1,309.4	1,283.6	1,264.8	-2%
EBITDA						
FRP standalone	112.1	108.8	105.7	102.7	99.7	-3%
VZ Northeast standalone	363.5	337.2	316.8	303.6	294.6	-5%
Synergies	35.0	67.0	75.0	75.0	75.0	21%
Consolidated	510.5	513.0	497.5	481.3	469.3	-2%
EBITDA Margins						
FRP standalone	40.5%	39.9%	39.3%	38.7%	38.1%	-2%
VZ Northeast standalone	32.5%	31.4%	30.4%	29.8%	29.4%	-3%
Consolidated	36.6%	38.1%	38.0%	37.5%	37.1%	0%

Source: JPMorgan estimates, Company data.

Table 10: Consolidated Capex Estimates

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
Revenue	1,394.8	1,346.9	1,309.4	1,283.6	1,264.8	-2%
x capex %	12.8%	12.5%	12.2%	12.2%	12.3%	
= Recurring capex	178.1	168.6	160.2	157.2	155.1	-3%
+ DSL buildout	44	0	0	0	0	
+ Systems conversion	128	0	0	0	0	
= Total capex	350.1	168.6	160.2	157.2	155.1	-18%

Source: JPMorgan estimates, company data.

Table 11: FCF Estimates

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
EBITDA	510.5	513.0	497.5	481.3	469.3	-2%
- Recurring capex	178.1	168.6	160.2	157.2	155.1	-3%
- Cash interest	179.0	171.7	156.4	140.5	123.9	-9%
- Cash taxes	0.0	0.0	0.0	0.0	0.0	
+ Pension & OPEB cash adjustments	30.0	30.0	30.0	30.0	30.0	0%
= FCF	183.4	202.7	210.9	213.6	220.3	5%
memo: FCF/share	\$2.09	\$2.31	\$2.40	\$2.43	\$2.51	5%
memo: FCF Yield	19.8%	21.9%	22.8%	23.1%	23.8%	

Source: JPMorgan estimates, Company data.

Table 12: FCF Uses

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
FCF	183.4	202.7	210.9	213.6	220.3	5%
- Dividends	90.8	90.8	90.8	90.8	90.8	0%
= Excess Cash	92.6	111.9	120.1	122.8	129.5	9%
memo: Payout ratio	50%	45%	43%	43%	41%	
Dividend/share	\$1.03	\$1.03	\$1.03	\$1.03	\$1.03	0%
x Shares outstanding	87.9	87.9	87.9	87.9	87.9	0%
= Dividends	90.8	90.8	90.8	90.8	90.8	0%

Source: JPMorgan estimates, company data.

Table 13: Leverage Outlook

\$ in millions

	2008E	2009E	2010E	2011E	2012E	CAGR ('08E-12E)
Debt, BOP	2,065	2,065	1,953	1,833	1,710	-5%
- Paydown	0	112	120	123	129	
= Debt, EOP	2,065	1,953	1,833	1,710	1,581	-6%
memo: Leverage	4.0x	3.8x	3.7x	3.6x	3.4x	
memo: Adjusted leverage	3.8x	3.6x	3.5x	3.3x	3.2x	

Source: JPMorgan estimates, company data.

Note: Adjusted leverage reflects \$30 million add back to EBITDA for pension and post retirement benefits (OPEB) accounting adjustments (cash paid is expected to be less than accounting expense).

Valuation, Rating and Price Target Analysis

Our January 2009 price target of \$15 suggests upside of 35-40% (plus dividend yield of 9%). We arrive at a higher value of \$18 based on FCF comps (adjusted FCF yield

is fully taxed and removes PV of NOL); however, we believe integration risk will stand in the way of full valuation for the next 18-24 months.

Table 14: Adjusted FCF Yield: 2008-2012

	2008E	2009E	2010E	2011E	2012E
Alaska	9.0%	10.4%	11.1%	11.8%	12.7%
CenturyTel	15.0%	14.7%	14.4%	14.1%	14.0%
Cincinnati Bell	10.8%	11.6%	12.2%	12.9%	13.7%
Citizens	12.5%	12.3%	12.4%	12.3%	12.3%
Consolidated	13.0%	15.2%	15.4%	15.3%	15.1%
Embarq	15.6%	15.6%	15.7%	15.3%	14.9%
Iowa	11.7%	11.6%	11.5%	11.5%	11.5%
Windstream	10.4%	10.2%	10.1%	9.9%	9.8%
Average	12.2%	12.7%	12.8%	12.9%	13.0%
Fairpoint (pro forma)	21.2%	22.7%	23.3%	23.2%	23.3%

Source: JPMorgan estimates.

Risks to Our Rating and Price Target

While the deal appears on track to close risks to our OW rating include: 1) integration risk - the combined entity will be about five times larger than FRP standalone (and management does not have a perfect track record with M&A integration); 2) index funds selling 5-8% of FRP stock if the deal closes (per shares issued to VZ stockholders); and 3) inability to reduce leverage to committed level of 3.6x by 2011.

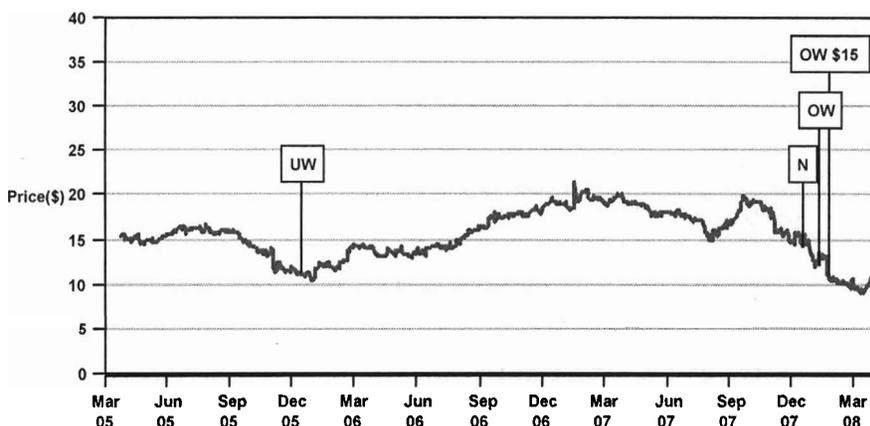
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- **Client of the Firm:** Fairpoint Communications is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company non-securities-related services.

Fairpoint Communications (FRP) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
16-Dec-05	UW	11.36	-
18-Dec-07	N	14.18	-
09-Jan-08	OW	12.12	-
24-Jan-08	OW	11.13	15.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
 Initiated coverage Dec 16, 2005. This chart shows JPMorgan’s continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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